

Internal Revenue Service
memorandum

TL-N-9470-87

CC:TL:TS/PHECK

date: OCT 22 1987

to: District Counsel, Denver SW:DEN

from: Acting Director, Tax Litigation Division CC:TL

subject: TEFRA Partnership/Subchapter S Corporation Basis Adjustments

This memorandum responds to your request of July 22, 1987, for technical advice concerning issues which have arisen in the TEFRA partnership and Subchapter S area.

ISSUES

1. Whether a partner's basis in a partnership is a partnership item, an affected item, or a nonpartnership item.
2. Whether a shareholder's basis in a Subchapter S corporation is a Subchapter S item, an affected item, or a non-Subchapter S item.

CONCLUSIONS

1. The determination of a partner's basis in his partnership interest generally involves several determinations, some of which can be made at the partnership level and others that can only be made at the partner level. To the extent that such determinations can be made at the partnership level, a partner's basis is a partnership item; to the extent that a partner-level determination is required, it is an affected item.
2. With respect to Subchapter S corporations, the same general principles apply. The temporary regulations suggest that any determination regarding a shareholder's basis would involve shareholder level information and, therefore, any basis adjustment would be an affected item or a non-Subchapter S item. The regulation, however, does not preclude a basis adjustment from being a Subchapter S item if the determination would otherwise be made at the Subchapter S level. It is worth noting that this issue is being addressed in draft regulations which purportedly will make shareholder basis determinations affected items.

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DISCUSSION

As a general matter, we agree with the conclusions reached in your June 26, 1987, memorandum sent to the TEFRA Coordinator, Quality Review Staff. It should be noted, however, that in applying the partnership audit provisions, an important distinction must be made between "classification" and "assessment" issues. Classification relates to the identification of an item as a partnership, affected, or nonpartnership item. Assessment relates to the mechanism by which changes in a person's tax liability are made.

The classification of an item will determine the appropriate forum for administrative and judicial review and the appropriate statute of limitations for assessing tax with respect to that item (I.R.C. §6229 vs. §6501). The tax treatment of any item defined to be a partnership item under Treas. Reg. §301.6231(a)(3)-1 is determined at the partnership level and is subject to administrative and judicial review under the partnership audit provisions (§§6221-6233). Certain enumerated partnership items are broad and translate directly into changes in tax liability. See paragraphs (a)(1)(i) through (v), (a)(2), and (a)(3) of section 301.6231(a)(3)-1. Other partnership items are more in the nature of determinations with respect to issues of fact or law and are merely one of several smaller determinations that would be needed in order to make a larger determination that results in a change in tax liability. See paragraphs (a)(1)(vi) and (a)(4) of section 301.6231(a)(3)-1.

The other smaller determinations that would be needed in order to make a change in tax liability may be either other partnership items or nonpartnership items. Where a larger determination (such as whether a partner is subject to the at-risk limitations) requires both partnership determinations (i.e., partnership items, such as the amount that the partner contributed to the partnership) as well as nonpartnership determinations (i.e., nonpartnership items, such as the source of the money contributed) that larger determination is an affected item. Although an affected item is subject to the partnership-level statute of limitations under section 6229, any resulting change in tax liability would not necessarily be assessed in the same way as changes resulting solely from application of partnership items.

The classification of an item therefore only provides the forum and timeframe in which that particular determination is finalized. It does not necessarily provide the appropriate

mechanism by which that determination is applied to a particular taxpayer in order to effect a change in tax liability. That mechanism is provided by either the TEFRA or deficiency assessment procedures.

Changes in tax liability resulting from application of partnership, affected, and nonpartnership items may be made through either assessment procedure depending on the type of determinations that must be made in order to make the change in tax liability. Section 6231(a)(6) provides that changes in tax liability to properly reflect the treatment of a partnership item are made through computational adjustments. Section 301.6231(a)(6)-1 provides that a computational adjustment may also include changes in tax liability reflecting changes in affected items. However, section 6230(a)(2)(A)(i) and section 301.6231(a)(6)-1(a) provide that changes in tax liability reflecting affected items that require partner-level determinations must be made through deficiency procedures and not through computational adjustments. Section 301.6231(a)(6)-1 provides examples of affected items that are assessed through each mechanism.

For example, the determination of a transferee's basis in his interest in a partnership that is subject to an election under section 754 is an enumerated partnership item under section 301.6231(a)(3)-1(a)(3). Since that determination is entirely a partnership item, changes in tax liability resulting from a change in that item are assessed through a computational adjustment. However, the determination of a partner's basis in his interest in a partnership in any other set of circumstances is not an enumerated partnership item. Consequently, one must look at the smaller determinations that are part of the larger determination of the partner's basis to see if those smaller determinations are themselves partnership items. Some determinations will be partnership items, such as the amount a partner contributed to the partnership as well as the amounts of partnership income, gain, deduction, loss, etc. that would cause basis adjustments. Others will not be partnership items, such as the amount paid by a transferee partner for his interest in a partner that is not subject to an election under section 754.

All partnership items (i.e., determinations) will be subject to the TEFRA procedures and will be finalized through the notice of Final Partnership Administrative Adjustment (FPAA). Once the FPAA is finalized, all changes in tax liability that result from applying partnership items and affected items that do not require partner-level determinations will be included in a

computational adjustment. In the case of a change in tax liability resulting from a change in a transferee partner's basis in his interest in a partnership that is not subject to an election under section 754, all determinations except the amount that the partner paid for his interest will be partnership items and will have been finalized through the FPAA.

The determination of such a partner's basis is an affected item because it requires both partnership and nonpartnership determinations. Since a partner-level determination must be made before any resulting tax is assessed, the tax must be assessed through the deficiency procedures. This allows the Service to conduct a partner-level inquiry into the price paid for the interest and allows the taxpayer a pre-payment forum to challenge that single partner-level determination.

While the above discussion also applies to Subchapter S corporations, you correctly point out in the memorandum that, in certain instances, an argument can be made that a basis adjustment can be a non-Subchapter S item and that the limitations provisions of section 6501 would apply. Temp. Treas. Reg. §301.6245-1T(c)(3) suggests that with respect to a Subchapter S corporation any determination regarding a shareholder's basis would involve shareholder level information and, therefore, any basis adjustment would be an affected item or non-Subchapter S item. The regulation does not preclude a basis adjustment from being a Subchapter S item if the determination would otherwise be made at the Subchapter S level. It is worth noting that this issue is currently being addressed in draft regulations which purportedly will make shareholder basis determinations affected items.

If you have any questions regarding this matter, please contact Patrick G. Heck at FTS 566-4174.

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